State of New Mexico
LEGISLATIVE FINANCE COMMITTEE

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LFC INVESTMENT REPORT FOR THE QUARTER ENDING MARCH 31, 2012

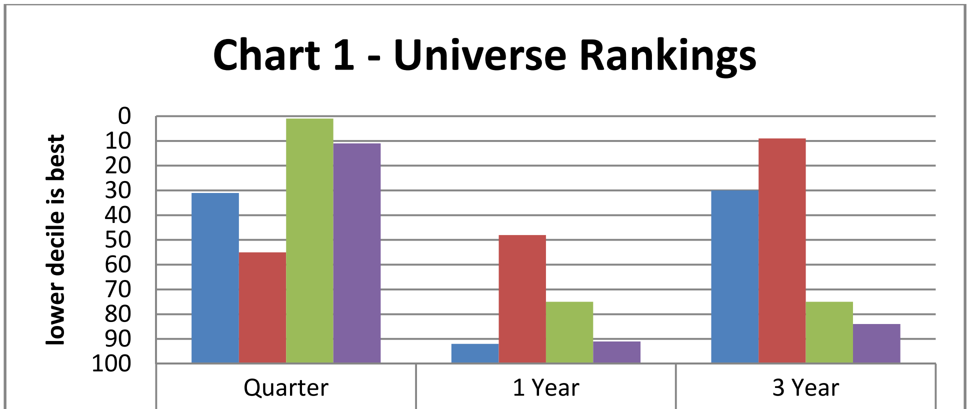
This report details the comparative investment performance of the three investment agencies: the Educational Retirement Board (ERB), the Public Employees Retirement Association (PERA), and the State Investment Council (SIC). It explains how the returns generated by the three investment agencies differed from that of the archetypical fund and how their management and consultants added and subtracted value. While this report necessarily concentrates on the quarter and can serve as a baseline, long term performance is indeed the most important metric. Therefore this report includes a long-run analysis of ERB’s investment performance. Future reports will focus on other investment agencies.

Table 1 shows percentage returns and ending balances. The returns and balances of the Severance Tax Permanent Fund (STPF) and Land Grant Permanent Fund (LGPF) are shown separately. A portion of the STPF is invested in economically targeted investments that yield below market returns; the LGPF does not have economically targeted investments in its portfolio and so is a better gauge of SIC’s performance. The difference in return between the two is a rough approximation of the opportunity cost of these initiatives. For the quarter ending March 31, 2012, economically targeted investments cost the state approximately $30 million in foregone income.

Table 1

Returns and Ending Balances				
	PERA	ERB	LGPF	STPF
Return (%)	8.00	7.19	9.45	8.68
Ending Balance ($B)	12.157	9.574	10.957	3.881

Chart 1 shows peer total return rankings for the agencies' large funds for the quarter, annually, and over a three year period. A lower rank (1st is best) denotes a better performance when compared to other funds. All of the comparisons are made using the Wilshire Trust Universe Comparison Service (TUCS), a benchmark for the performance and allocation of institutional assets that includes approximately 900 plans representing nearly $3 trillion in assets.



	Quarter	1 Year	3 Year
PERA	31	92	30
ERB	55	48	9
LGPF	1	75	75
STPF	11	91	84

For the quarter, PERA turned in a return in the upper third. This is consistent with their longer term performance and well above their poor one-year results. ERB returned a middling to below average performance, consistent with their one-year performance, and in contrast to their good three-year performance. SIC (LGPF/STPF) recorded the highest return for the quarter, in contrast to their poor one-year performance and their three-year average.

Attribution Analysis.

There are three basic ways that a fund's returns can differ from the average: the policy, allocation, and manager effects.

Quarterly Policy Effect.

A fund can have a long-term policy allocation (known as the "policy index") target that has a more or less aggressive proportion of risky assets such as stocks. For example, risky domestic assets such as US stocks (equities) performed best in the first quarter. Accordingly, an index that has more domestic equities should outperform the average. Measured in isolation, such a change in performance is known as the "policy effect," and it is an essential responsibility of the fund's trustees. The most appropriate measurement of a policy allocation benchmark is comparison to a defined peer group.

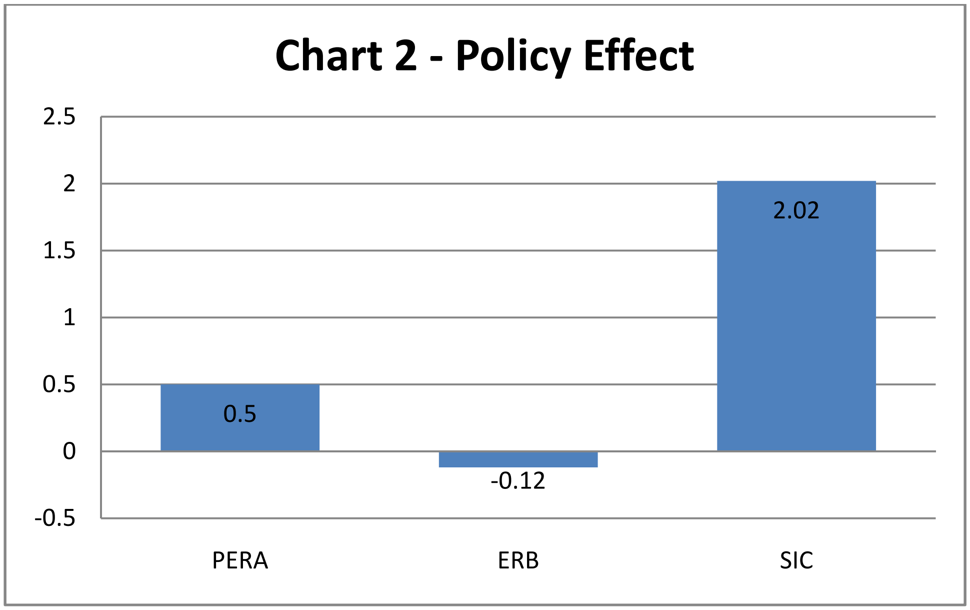
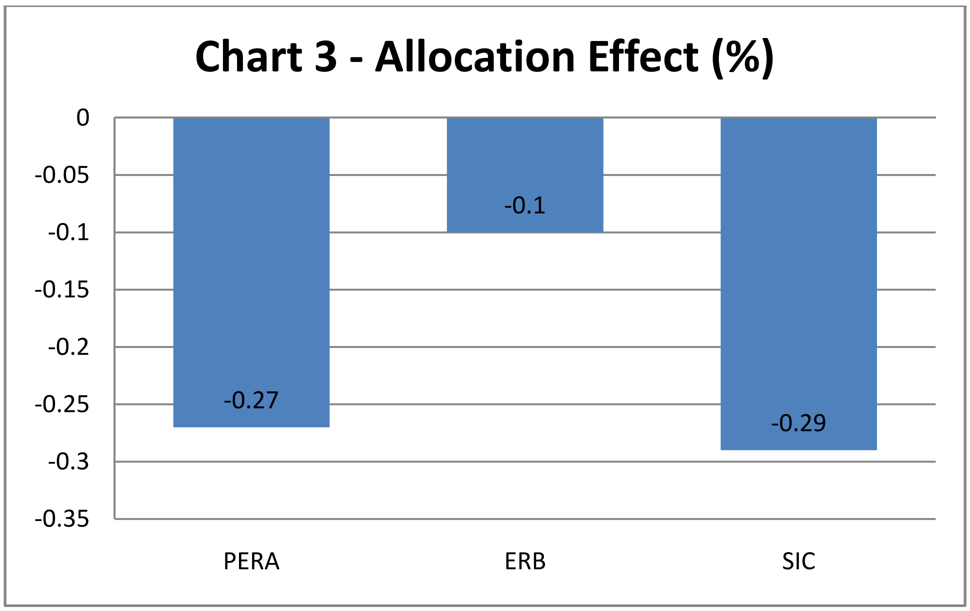


Chart 2 shows the funds' policy effect as measured against the TUCS median fund actual return. The measure for the target fund is gross of the allocation and manager effects, and is therefore a rough estimate of the policy effect. However, this report uses this measure to allow uniformity and consistency across the three funds. In isolation, PERA's policy yielded 0.5 percent more than the median fund. This is because their index holds more international equities than is the median fund. Although they performed well during the quarter, international equities lagged domestic equities. In comparison, SIC's policy index is more heavily weighted toward domestic assets such as domestic equity and, in isolation, delivered (relatively) high returns, as indicated by a policy effect of over two percent. It should be noted that both PERA's and SIC's policies feature heavy exposure to international and domestic equities (54 percent and 58 percent, respectively), while ERB's policy called for a lesser exposure to equities (40 percent) in favor of fixed income assets. This less risky policy contributed to ERB policy index performing 0.12 percent below the median fund performance during a quarter when the market rewarded risk.

Quarterly Allocation Effect.

The second way that a fund's return can be affected is by tactically shifting assets away from the proportions called for by policy. This is arguably the best measure of the value added from a chief investment officer. For example, an investment officer might have had a bearish view of the stock market during the first quarter and used his authority to temporarily reduce a fund's risky assets to less than what is specified in policy. Since stocks had a good quarter, reducing risky assets would have been a bad market call and would have subtracted from fund performance. As a matter of practice, investment officers are constantly confronted with allocation decisions when transitioning or rebalancing portfolio managers or asset classes. The investment officer may have the option of letting the money sit in cash or incurring the cost of temporarily covering the allocation through the futures market or some other avenue, depending on policy authority. Tactical investment authority afforded the chief investment officer is dictated by investment policy, resulting in differing degrees of authority delegated by each fund.

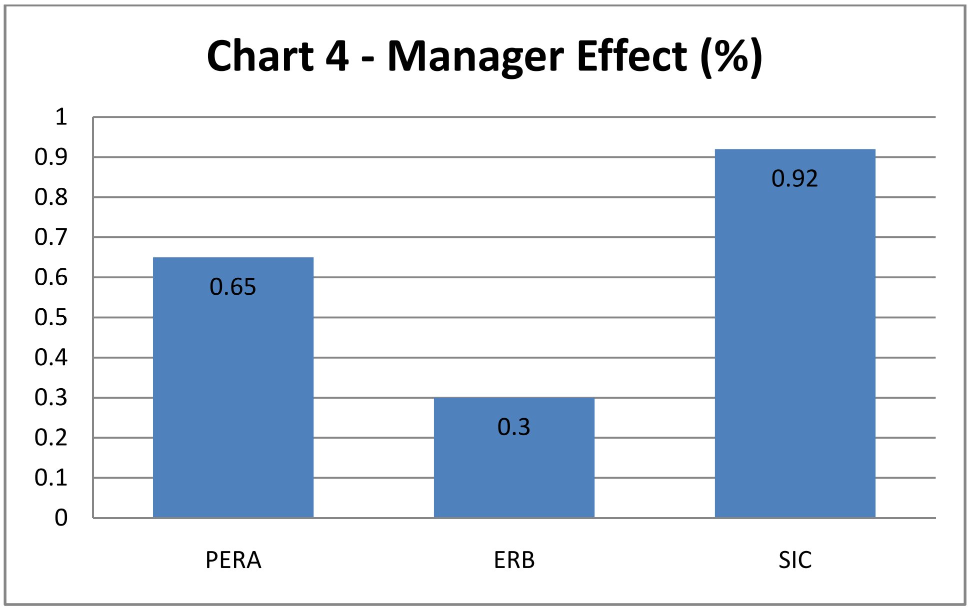
The difference between the funds' temporary and long term allocation is known as the "allocation effect" and is interpreted as investment return added or lost. Chart 3 shows the quarterly effect graphically; all three funds lost value by deviating from their policy index. PERA lost 0.27 percent from the market effect of an underweight in international equities and a slight overweight in fixed income. ERB's return would have been 0.10 percent higher but for rebalancing decisions; and SIC's returns would have been 0.29 percent higher but for the value lost by deviating from policy. Allocation gains or losses occur constantly – asset proportions vary against targets because of market price changes and incoming and outgoing cash flows, which are also variable.



Quarterly Manager Effect.

The third way that value can be added or subtracted from a fund is through the use of active management. For example, a fund can buy a security such as the institutional version of the Standard & Poor's Depository Receipts (SPDRS) commonly used by retail investors. These securities are composed of a relatively fixed basket of securities that track the S&P 500 index. Alternatively, the fund can employ a manager who will trade individual securities given his attitude about the prospects of individual stocks. This is known as "active" investing. The difference between the return of the index and the portfolio of the active manager is known as the "manager effect".

As Chart 4 shows, PERA's managers' added 0.65 percent to return, and managers for ERB and SIC added 0.30 percent and 0.92 percent to returns, respectively. Contributing to the large gain for SIC were large cap equity managers such as Thornburg, which outperformed its benchmark by 353 basis points. Thornburg's performance is noteworthy because it missed its benchmark for the previous quarter by 4.73 percent and has resigned its account with SIC. Also of note is the performance of SIC's internally managed portfolio, which outperformed its benchmark by 272 basis points. The swing in Thornburg's returns raises questions about the efficacy of large cap active management in an efficient market. The efficient market hypothesis asserts that financial markets are "informationally efficient," and that due to this efficiency, one cannot consistently achieve returns in excess of average market returns. Future quarterly investment reports will continue to explore this issue.



The funds' 4th quarter performance can be summarized as follows:

- Using the TUCS, it is possible to rank the funds against the same universe.
- PERA's return was above average for the quarter. Their emphasis on international equity over domestic equity put the fund at a slight disadvantage to the SIC. PERA's temporary deviation from long-term allocation targets due to market impact resulted in lost value. However, superior active investment management offset these negative impacts.
- ERB turned in a performance that was below average because their emphasis on less risky assets put them at a disadvantage in a quarter where risk was rewarded. The slight loss of value due to deviation from allocation targets was offset by the manager effect.
- SIC quarterly performance was above average. SIC's policy index put them in a good position to benefit from strong performance of risky assets. Weakness due to temporary deviations from their policy is more than offset by good equity manager performance.

<u>ERB Long-term Analysis.</u>

Chart 5 shows the ERB's performance for the quarter, year-to-date, and three-year average. In terms of policy, compared with the TUCS, ERB shows a minimal effect for the quarter and the year, but it outperforms the policy index by 258 basis points over the last three years, indicating that the market rewarded its policy of relatively conservative asset allocation during that time.

Over the past three years, the allocation and manager effects sum to 2.2 percent. ERB has taken an active role in rebalancing within the limits of each asset class. ERB notes that, when given the discretion to do so, rebalancing, or deciding not to rebalance, are active management decisions. ERB's activity within the allocation targets added 0.9 percent to the fund's performance. Further, ERB's securities selection in the long run has resulted in a positive manager effect, adding 1.3 percent to fund performance. ERB's expectation for both the allocation and manager effect is that neither will cause large fluctuations to overall performance in the short run. To position either to cause large fluctuations would necessitate taking unduly large risks. Ideally, both effects will provide modest but consistent positive contributions to overall portfolio performance. Over time, these modest contributions are expected to aggregate to greater outperformance as demonstrated in the three year period in the chart below.